

# [Vodafone equity valuation](https://assignbuster.com/vodafone-equity-valuation/)

We believe Vodafone to be slightly undervalued due to the intrinsic value within its portfolio that is not recognised in the share price. It is a well known phenomenon/anomaly that the equity-market is valuing Vodafone at a discount to fundamental value. Certain assets controlled by the group are failing to adequately contribute to Vodafone’s share price.

Analysts disagree to the extent with which the market is discounting the price from its sum-ofparts. We take the view that the disposal value of the group is 188. 2p – giving a potential 38% upside on our recommendation. This valuation is based on the premise that management adhere to the outlined strategy to realise this value through divestures and disposals of select underperforming assets such as Verizon Wireless (VZW) and SFR. Patience may be required for the group to realise value in this manner, however the stock is still supported by a 6.

81% Dividend yield (8. 31p) with an annual targeted growth of 7%. Our view is further supported by recovering cyclical demand in Europe as Macro conditions improve (Spain excepted) and continued improvements in margin and Cash flow management. Rating: BUY Analyst: Myles Carey Vodafone Group Plc Vodafone House The Connection, Newbury Berkshire ENG RG14 2FN United Kingdom Contact: Kate Hinksman (Sr.

Investor Relations Manager) http://www. vodafone. com/ Company Data Price Date of Price Price Target Capital upside 52-week range (price) Div Yield Float (mil) EPS Mkt Cap Options Vol. (1M avg) Sector View 157 28/08/2010 188.

2 38% 112. 90 – 161. 94 8. 31 (6.

81%) 5257. 47 16. 4p 74. 79B 255, 873, 913 Hold 12 month Price performance Investment Highlights: ? 6.

% dividend yield with annual growth of 7% targeted going forward. With the BOE keeping rates at record lows (0. 5% as of 6/09/10), well below inflation rates (2009 CPI 2. 9%), Investors are looking elsewhere to generate yield-based returns.

We believe that strong defensive stocks like Vodafone will benefit from this dynamic on both sides of the Atlantic. Strong cash generative core businesses with exceptional recent free cash flow growth yoy (see table on the right) Free Cash Flow Performance FCF 2009 7241 5722 5580 FCF Growth Yoy 27% 3% N/A 2008 2007 September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] ? Value Focus: CEO Vittorio Coloa has repeatedly stated that the focus on value is concentrated on controlled assets in Europe, India, stake in VZW and the sub-Sahara. We thus envisage a realisation of value through a series of divestitures and transactions in the coming year o China Mobile – 3 % stake o Bharti – Residual 4% stake o VZW: Vodafone owns 45% o Softbank Japan – preferred shares o SFR – 44% stake with Vivendi the controlling shareholder.

Vivendi has long signalled 100% ownership as its objective o Vodafone Egypt: 55% stake Realisation of improved organic revenue trends derived from strong and continued investment throughout the downturn (see valuation) CFC Tax settlement to cost ? 1. 5bn (2. 2p per share): Vodafone has reached an agreement with respect to all outstanding CFC issues. This is well below a balance sheet provision of ? 3. 1bn Recent Results are in line with expectations and management guidance. Institutional ownership: Holder Shares held 3.

02bn 2. 11bn 1. 08bn 984. 02m 905. 7m % of Shares held 5. 73% 4.

00% 2. 04% 1. 87% 1. 72% BlackRock IM Legal & General IM Scottish Windows IP Norges Bank M&G IM source: Thomson Reuters Insider Trading: Type Pur Name & Title V A Colao CEO M Combes CEO Eur V A Colao CEO AN Halford CFO S Pusey CTO # Shares 541, 057 Price 144. 18 ? Pur 275, 960 144. 18 Sale 198, 603 151.

47 ? Sale 151, 797 151. 47 Pur 81, 690 144. 18 ? Close Competitors Vodafone Group Plc – Company Quality Company BT Group Verizon AT&T source: Capital IQ Dividend Yield 5. 1% 6.

5% 6. 4% Source: Reuters ProVestor Plus September 6, 2010 EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] BUSINESS SUMMARY Overview: Vodafone Group Plc is the world’s leading mobile telecommunications company, providing a range of communication products and services, including voice, data solutions and messaging. Vodafone operates in the mobile sector of the telecoms industry and comprises 7% share of the global market1. The Group generates approximately 80% of its revenues through voice and messaging services, while the residual revenue is derived from less traditional, high growth avenues like broadband and mobile data services.

The group has a significant presence in Europe, the Middle East, Africa, Asia Pacific and the United States through the Company’s subsidiary undertakings, joint ventures, associated undertakings and investments. 2 Vodafone had an estimated 347m customers as of the 30th June, 2010 including those customers of the ventures in which it has ownership stakes (calculated on an interest-proportional basis). Vodafone is a minority shareholder in Verizon Wireless in the United States, with a 45% stake. In addition, Vodafone absorbed Vodacom Group Ltd into the group as a subsidiary when on the 20th April, 2009; it acquired a further 15% stake in Vodacom and consequently terminating the pre-existing shareholder agreement with Telkom SA Limited. Other notable subsidiaries include Vodafone Australia, Swisscom and Vodafone Turkey.

Strategy: Within the mobile sector, Vodafone operates in what is known as Layer II (the Network Layer) of the basic layer model. 3 According to this model there are two possible strategies employable; Layer II specialisation with geographic expansion, or vertical integration. It is patently evident that Vodafone has decided to pursue a geographic expansion strategy since first merging with AirTouch, a global U. S.

network operator of mobile communications, 11 years ago. As a result Vodafone’s core operations are focussed in a mix of steady, mature markets and high growth areas like Turkey and India where it has a powerful presence. Vodafone’s strategy has also seen its business shift from a mobile giant to a total communications provider within the ‘ Network Layer’ with a third of its service revenue generated from products other than mobile voice. Another feature of the strategy and business model employed by Vodafone has seen management successfully seek to manage costs and working capital, especially during the credit crisis.

This approach has recently been scaled up with the announcement of a further ? 1bn cost cutting target to be met by 2013. Vodafone’s geographic diversification is the key driver to revenue growth at the moment as developed markets remain quite weak. Vodafone are now the number two operator in India despite intense competition and have delivered 4. % growth in South Africa last year and 31. 3% in Turkey in the last quarter as 3G services and Smartphone’s are rolled out.

It is with these strategies in mind that we analyse Vodafone’s business portfolio and prospective revenue generation, especially the potential revenue and market share the group can achieve in fast growing markets such as India, Eastern Europe and potentially China. 1 2 Vodafone 2010 Annual Report www. vodafone. com 3 www. telecomvisions.

com/mobile/question2. phpSeptember 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] SWOT ANALYSIS Strengths ? Strong cash-generative core businesses ? Past strategic aim to become “ the Coca-Cola of mobile” has created a diversified geographical portfolio with strong mobile telecommunications operations in Europe, the Middle East, Africa, Asia Pacific and the US (see Figure 1) ? Sophisticated and extensive network infrastructure with exceptional, and rapidly improving, peak mobile download speeds (see Figure 2) ? Leading presence in emerging markets such as India and Turkey which has driven recent outperformance ? Strong footprint and brand in profitable urban areas ? Strong new Management and clear strategic vision (to streamline business and realise value) Figure 1 Figure 2 Weaknesses ? Minority partner in US business (Verizon-Wireless) which is debt laden and weaker than European/ROW operations ? Majority of business focused in Europe where pricing pressures remain and competition is intense ? No/weak network in rural areas ? Data and voice prices are set to continue declining in the short/medium term ? Absence of growth has seen Vodafone’s valuation suffer Opportunities Management guidance – “ we intend to accelerate our strategy to drive shareholder value and take advantage of the widespread adoption of data”. ? ? ? ? ? ? Realisation of shareholder value through select group disposals (see Valuation) Focus on cost reductions improving returns – Management have announced a target of ? bn cost savings by 2013; half of which will be available for investment and margin augmentation Total communications growth: continued Data revenue growth from PC connectivity services and increased Smartphone penetration Research and development of new mobile technologies Positive growth prospects in emerging markets, especially Africa and India where the group now has more than 100m customers Further commidization of Vodafone’s products and services (Vodafone providing branded applications and services to users of other operators)4 http://disruptivewireless. blogspot.

com/2009/06/under-floor-to-over-top. html September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] Threats ? ? ? ? ? Vodafone operates in a highly competitive market with very low technological barriers to entry and many small powerful buyers in the residential market Vodafone has high penetration rates in key European markets which are at risk from: -increased regulation with respect to roaming and termination rates -lower demand due to ineffectual austerity measures and structural weakness India may continue to drain Free cash flows to finance the margin on the $5bn put option and future spectrum costs, and thus impact valuation Groups such as Apple impinging on Vodafone’s value chain through commidization of their product’s ‘ complements’5 Our analysis is based on the assumption that Verizon Wireless will commence payments of Dividends once the group’s debt is cleared. If there is a threat to this in the short term it will directly impact the valuation of this 45% stake.

-Some analysts envision a situation where Verizon (the Majority shareholder) withholds dividends in an effort to force Vodafone to sell their stake to them at a discount -Vodafone currently does not receive any cash from this stake and our analysis forecasts a sale (as alluded to by CEO Coloa) which would include a control premium that Verizon should, we believe, be forced to pay for 100% control TELECOMS INDUSTRY (mobile sector) Overview: The telecoms industry has 4. 7bn mobile customers globally, up from 2. 7 billion in 2006; this equates to growth of greater than 20% pa. Large population developing markets such as China and India account for the majority of customers and growth. In comparison growth in more mature markets such as Western Europe and the US is muted. Global penetration of mobiles is ~70%, up from ~40% in 2006.

7 Trend: Mobile service is coming to increasingly dominate the telecoms landscape as customers more and more choose to make voice calls using mobile phones rather than fixed phones. Fixed calls accounted for a mere 30% of calls in 2009, down from 50% in 2006. Mobile calls now account for 70% of traffic and the number of users now far exceeds those of fixed phones. Voice revenue accounted for 67% of Vodafone’s revenue in 2010 (see Figure 4). The mobile sector is rapidly evolving thanks to major technological advances and the proliferation of Smartphone use in tandem with faster download and data use speeds.

Telecom is less about voice and progressively more about text and images. The industry continues to move more towards 3G (Third-Generation), which allows faster connectivity and can handle more data, rather than 2G networks. In addition Vodafone is now testing 4G technologies which offer even faster network speeds to enhance the customer experience. 5 6 http://mobilesociety.

typepad. com/mobile\_life/2009/07/commoditization. html http://www. informationweek.

com/news/telecom/showArticle. jhtml? articleID= 197005460 7 Vodafone 2010 Annual Report September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)]In addition to the developed countries where networks are established and user growth is negligible, there are vast opportunities in developing countries, especially in middle income countries, such as China, India and those in Eastern Europe, where mobile communications penetration and consumer sophistication are expected to continue growing rapidly over the next five years.

Figure 3 Figure 4 Regulation: The Telecom, and mobile, industry has seen rapid and widespread deregulation in the past decade, beginning with the Telecommunications Act of 1996. This has been driven by the explosion of innovation and fast pace of technological change in this time. In many countries around the world, government monopolies have been privatised and face ever increasing levels of competition. Furthermore industry regulators continue to impose lower termination rates (the fees mobile companies charge for calls received from other companies’ networks) and lower roaming prices, which accounted for 17% of Vodafone’s Group revenue in 2010. 8 Competition: The mobile telecom industry is a highly competitive market with many large multinational players and, increasingly, newer, smaller competitors competing in specific segments. This increase in competition is being driven in part by is the key role played by specialist technology suppliers, a unique structural feature of the new telecoms industry.

This vertical specialisation has served to recently lower the barriers to entry in the telecommunications market. New competitors now have the ability to purchase the required technology without first having to develop in-depth technological competencies. This has two effects for large corporations such as Vodafone: 1. Their market position is less secure from new entrants who can overcome the large economies of scale and in-house technological expertise of incumbents.

2. The degree of possible differentiation has been lowered owing to easy technological access, making it difficult for all players to differentiate their product. 8 Vodafone 2010 Annual Report September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD.

L, VOD LN)]As a result Vodafone and other operators have come to rely on their ability to construct superior forms of corporate structure and organisation, such as customer care and service quality, to differentiate their brand. Another issue with competition for mobile operators is market segmentation whereby small consumers have strong buying power with many similar options to choose from and price sensitive tendencies, and large corporate customers are more indifferent to price and instead focus on reliability and quality. Competitive Position Barriers to Entry: High (decreasing) ? large economies of scale, regulatory issues (spectrum & licenses)and access to Capital Markets ? Important technological barriers to entry are declining (see note) Product Substitution: Low ? Mobile is a cyclical and fast evolving business with new technologies emerging constantly ? Disruptive technologies are often discussed but no distinct threat has of yet emerged Supplier Power: Low ? Telecommunications firms have a strong bargaining position due to decreasing CapEx budgets, pooling of sources among firms and, recently, excess industry capacity Buyer Power: Medium ? Small residential buyers have high buying power with churn rates quite high and firms competing on price ? Corporate customers focus on quality, data security and reliability of service and have lower buyer power Inter-firm Rivalry: Medium (increasing) ? Mobile market is competitive and technology may see opportunities for smaller, innovative firms September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)]Performance: The telecommunications sector as a whole has seen declining revenue since the financial crisis but it has not seen the extremely steep declines in revenue experienced by some other sectors of the economy – mobile communications remain an essential element in most people’s lives.

9 The sector has performed broadly in-line with the wider market YTD (see graph below). On a positive note the uncertainty from spectrum auctions has now cleared and there seems to be signs of revenue easing the declines of recent quarters and possible returning to growth in Europe. Source: Bloomberg Seasonal relative performance: Telecoms have a statistical history of H1 underperformance and H2 outperformance stretching back 15 years. This trend as largely reversed in H2 2009 and H1 2010 suggesting that sector volatility is responding strongly to macro related information as opposed to following “ typical” trading patterns reflecting sector seasonality.

Most stocks that dominate the sector are high yielding, defensive names that are extremely cheap when compared to the relative yields available on bonds. Looking ahead the sector can expect an easier time of it with regard to regulatory concerns now that most major spectrum auctions have been completed for the coming months (e. g. Germany and India) and increased competition and customer choice enabling Ofcom to have a more hands off approach as outlined in a recent discussion paper, “ At the current time we (Ofcom) do not think there is compelling evidence of anti-competitive behaviour.

9 We expect a continued broad correlation between revenue trends, sector performance and macro seasonality with those firms who can maintain and increase margins benefitting the most in terms of share price performance. We believe that the larger firms with excess capacity, such as Vodafone, can best achieve this, provided Global and European market recovery does not falter. 9 Ofcom discussion document: ‘ Traffic Management and net neutrality’ Section 6. 4 September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] Valuation – Sum of Parts ? ? ? ? Our sum-of-parts valuation of Vodafone of 188.

2p includes no discount for a minority stake in VZW and a premium for control on the disposal on SFR as indicated by likely disposal valuations. Reductions to the group’s FCF include deductions for the impairment on the purchase of Essar as outlined by the board, the likely CFC tax liability in India and a consensus view on the likely new license and spectrum spend over the next 12 months The valuation methods for the separate ‘ parts’ are outlined in the appendix. This valuation indicates a dividend yield of 4. 7% by March 2011 with the Equity Stub forecast to trade at 8.

9x EBITDA by 2013 after the divestures. Using a WACC of 9. 3% and terminal growth of 1. 05%, this gives a valuation of 112p per share (see below). (Detailed revenue forecasts for the stub can be found in the appendix) September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD.

L, VOD LN)] ? Our Dividend Discount Analysis gives Vodafone a valuation of 173p. The indicated Annual Dividend Rate is ? 8. 31 a share giving Vodafone Group Plc a current yield of 4. 95%.

We use this analysis as a supplement to our DCF and relative valuations due to the unique manner in which Vodafone is being valued by the market, especially the issues surrounding VZW and its current non-payment of Dividends which is underestimating the true value of the firm at this moment in our opinion. ? For Risks to our valuation please refer to our SWOT analysis, especially the threats section. September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)]APPENDIX Financials-Balance Sheet In Millions of GBP (except for per share items) Cash and Short Term Inv Total Receivables, Net Total Inventory Prepaid Expenses Other Curr. Assets, Total Total Current Assets Prop.

/Plant/Equip. – Net Goodwill, Net Intangibles, Net Long Term Investments Note Rcvble – Long Term Other Long Term Assets Total Assets Accounts Payable Accrued Expenses Notes Payable/ST Debt Curr. Port. LT Dbt/Cap Ls.

Other Curr. Lblts, Total Total Current Liabilities Total Long Term Debt Total Debt Deferred Income Tax Minority Interest Other Liabilities, Total Total Liabilities Common Stock Additional Paid-In Capital Ret. Earn. (Accum.

Deficit) Treasury Stock – Common Unrealized Gain (Loss) Other Equity, Total Total Equity Total Liabilities & Shareholders’ Equity 1, 699 4, 121 417 2, 426 61 8, 724 16, 735 51, 336 18, 995 29, 912 236 831 127, 270 2, 985 8, 164 47 4, 485 6, 292 21, 973 22, 662 27, 194 5, 109 -1, 572 1, 055 49, 227 4, 182 143, 085 -71, 926 -7, 856 -10, 558 78, 043 127, 270 4, 878 4, 622 412 2, 868 249 13, 029 19, 250 53, 958 20, 980 41, 775 479 2, 590 152, 699 3, 178 9, 020 2, 691 6, 933 6, 125 27, 947 31, 749 41, 373 6, 642 -1, 385 1, 584 66, 537 4, 153 153, 348 -83, 820 -8, 036 180 20, 337 86, 162 152, 699 4, 811 5, 345 433 3, 448 182 14, 219 20, 642 51, 838 22, 420 43, 968 737 2, 094 156, 985 3, 271 10, 062 2, 623 8, 540 4, 120 28, 616 28, 632 39, 795 7, 377 429 1, 550 66, 604 4, 153 153, 509 -79, 655 -7, 810 1, 040 19, 144 90, 381 156, 985 Mar 31 2008 Mar 31 2009 Mar 31 2010 September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] Financials-Income StatementIn Millions of GBP (except for per share items) Total Revenue Cost of Revenue, Total Sell/General/Admin. Expenses, Total Unusual Expense (Income) Other Operat Expse, Total Total Operating Expense Operating Income Other, Net Net Income Before Taxes Provision for Income Taxes Net Income After Taxes Minority Interest Net Income Before Extra. Items Total Extraordinary Items Net Income 35, 478 21, 890 6, 389 0 28 25, 431 10, 047 -145 9, 001 2, 245 6, 756 -96 6, 660 0 6, 660 41, 017 25, 842 7, 509 5, 900 0 35, 160 5, 857 37 4, 189 1, 109 3, 080 -2 3, 078 0 3, 078 44, 472 29, 439 8, 309 2, 100 -114 34, 992 9, 480 168 8, 674 56 8, 618 27 8, 645 -8, 645 Mar 31 2008 Mar 31 2009 Mar 31 2010 Financials-Cash Flow StatementIn Millions of GBP (except for per share items) Net Income Depreciation/Depletion Non-Cash Items Cash Taxes Pd, Supplemental Cash Interest Pd, Suppl Changes in Working Capital Total Cash from Operations Capital Expenditures OtherInvestCashFlowItms, Tot Total Cash from Investing Financing Cash Flow Items Total Cash Dividends Paid Iss (Retirmnt) of Stock, Net Iss (Retirmnt) of Debt, Net Total Cash From Financing Foreign Exchange Effects Net Change in Cash 6, 756 5, 909 -1, 653 2, 815 1, 545 -538 10, 474 -4, 698 -3, 846 -8, 544 -1, 665 -3, 658 310 -2, 852 -7, 865 129 -5, 806 3, 080 6, 814 3, 615 2, 421 1, 470 -1, 296 12, 213 -6, 968 134 -6, 834 -1, 029 -4, 013 -941 3, 427 -2, 556 371 3, 194 8, 618 7, 910 -1, 585 2, 273 1, 601 -1, 879 13, 064 -6, 975 -462 -7, 437 -1, 044 -4, 139 70 -740 -5, 853 -257 -483 Mar 31 2008 Mar 31 2009 Mar 31 2010 September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD.

L, VOD LN)] Prominent Sum-of-parts Valuations September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] Equity Stub Valuation Mobile Customers (m)Western Europe 16% 10% 19% 16% 11% 10% 7% 11% Eastern Europe USA/ Canada India China Other Asia Pacific Africa Europe Semi-Annual Revenue Expectations September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] 130 120 93 45 54 69 48 Western Europe Eastern Europe USA/ Canada India China Other Asia Pacific Africa 24.

0 Outgoing voice prices ; minutes (% Change) 22. 7 12. 4 (16. 8) 2008 (12.

5) (21. 8) 2009 2010 Asia Pacific and Middle East Semi-Annual Revenue Expectations September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD. L, VOD LN)] Africa and Central Europe Semi-Annual Revenue Expectations Equity Stub Model Assumptions and Free Cash Flows (FCFs) September 6, 2010 [EQITY RESEARCH REPORT: VODAFONE. (VOD.

L, VOD LN)]